APPENDIX: EXAMPLES OF LACK OF CLARITY AND POTENTIAL FOR MMS DISCRETION TO ADD UNCERTAINTY

1. **§ 206.101 Definitions** *Arm's-length contract means a contract or agreement between independent persons who are not affiliates and who have opposing economic interests regarding that contract.*

   By defining as arm's length only those contracts or agreements in which parties both do not meet MMS' definition of affiliates and have opposing economic interests, MMS has ruled out the very real possibility that arm's length transactions can occur between parties who fit MMS' definition of affiliates but have opposing economic interests for the purposes of that transaction. This is not a mere theoretical possibility, but characterizes some actual market transactions. For example, several competing producers might be co-owners of a marketing company or pipeline. Although one or more of these owners might be classified under MMS' proposed rule as "affiliates" of this joint venture, the directors of the joint venture generally would be obligated to exercise a fiduciary responsibility with respect to the collective interests of all the co-owners (who are competitors in the production businesses) in that venture. In this case, transactions between the joint venture and any of its owners can clearly meet the test of "opposing economic interests," and thus be at arm's length. MMS needs to more carefully consider how its delineation of arm's length and non-arm's length would apply in practice.

2. **§ 206.101 Definition of Affiliate (2)** *If there is ownership or common ownership of between 10 and 50 percent of the voting securities or instruments of ownership, or other forms of ownership of another person, MMS will consider the following factors [t-v] in determining whether there is control under the circumstances of a particular case.*

   MMS has revised its definition of an affiliate so that lessees will have an opportunity to rebut the presumption of control for ownership between 10 and 50 percent. However, the definition of an affiliate still leaves much scope for the MMS to make a discretionary decision regarding the treatment of such as a relationship. The proposed rule lists a number of factors that may be considered in judging whether control exists, but fails to specify how these facts and circumstances will be judged and what materials and documentation companies will be required to submit to MMS for a determination of the issue. Nor does the MMS include an estimate of the time and expenses that it and affected lessees will have to expand in deciding whether companies are affiliates.

3. **§ 206.102(a)** *The value of the oil under paragraphs (a)(1) and (a)(2) of this section is the gross proceeds accruing to the* ***seller*** *under the arm's-length contract, less applicable allowances determined under this subpart, unless you exercise an option provided in paragraph (d)(1) of (d)(2) of this section.*

Under an arm's-length contract, MMS has changed the party to whom gross proceeds[37] accrues, from the "lessee" in the 1988 regulations to the "seller" which may be an affiliate or an other person in the proposed rule. This deceptively small change has large implications. The current regulations specify gross proceeds of the lessee, while under the proposed rule, MMS is attempting to trace gross proceeds through multiple parties if "[y]ou sell or transfer to your affiliate or another person under a non-arm's-length contract and that affiliate or person, or another affiliate of either of them, then sells oil under an arm's-length contract." By use of the term "person," this language allows MMS to even trace value through unaffiliated parties. As a result, MMS has a great deal of discretion, and all parties involved in such transactions will face much more uncertainty. This is a method for tracing through to downstream dispostions in an attempt to capture downstream values in a different market, which we and others have repeatedly argued to be inappropriate.

4. **§ 206.102(c)(1)** *In conducting reviews and audits if MMS determines that any arm's-length sales contract does not reflect the total consideration actually transferred either directly or indirectly from the buyer to the seller, MMS may require that you value the oil sold under that contract either under § 206.103 or at the total consideration received.*

This provision appears to allow MMS the discretion to require that index-based pricing be used in the case of an arms-length sale if, for example, MMS disagrees with how the lessee calculated applicable allowances.

5. **§ 206.102(c)(2)** *You must value the oil under § 206.103 if MMS determines that the value under paragraph (a) of this section does not reflect the reasonable value of the production due to either: (i) Misconduct by or between the parties to the arm's-length contract; or (ii) Breach of your duty to market the oil for the mutual benefit of yourself and the lessor.*

Under part (i) of this paragraph (and elsewhere in the proposed rule), MMS leaves open how it will interpret the concept of a "breach of your duty to market the oil for the mutual benefit of yourself and the lessor." The meaning and extent of the "duty to market" is left undefined by the proposed rule and is an issue that is currently the subject of litigation.

6. **§ 206.102(d)(1)** *If MMS determines that any arm's-length exchange agreement does not reflect reasonable location or quality differentials, MMS may require you to value the oil under § 206.103.*

MMS has reserved the discretion to over-ride arms-length differentials and to require index-based pricing if it determines that the location and quality differentials applied by a lessee in an arms-length exchange are not reasonable. At no point in the proposed rule does MMS

37 See definition of "gross proceeds" 64 Fed. Reg. 73843 and Sec. 206.102(a).

state how and according to what objective criteria or benchmarks "reasonableness" will be determined. The failure to provide up-front guidance on this central valuation issue will leave lessees open to significant audit risk, and will cause uncertainty and administrative burdens for both lessees and the lessor.

7. **§ 206.103(b)(4)** *If you demonstrate to MMS's satisfaction that paragraphs (b)(1) through (b)(3) of this section result in an unreasonable value for your production as a result of circumstances regarding that production, the MMS Director may establish an alternative valuation method.*

   MMS provides no objective standards for reasonableness – what valuation results from the proposed index-based method will be judged sufficiently unreasonable to allow an alternative method to be used. In addition, MMS does not prescribe any guidance or limits on the alternative valuation methods that the Director might allow or require.

8. **§ 206.103(c)** *Value is the average of the daily mean spot prices published in an MMS approved publication: (1) For the market center nearest your lease for crude oil similar in quality to that of your production ...*

   The guidance provided on which market center and spot price to use under the index price valuation is ambiguous and insufficient. The proposed rule does not state how "similar" will be determined, or whether similarity or proximity to the lease will take precedence in cases where the two criteria are in conflict. For example, in a case where the closest market center has an MMS-approved published spot price for a dissimilar crude oil, when and how far away should the lessee look to find a price of more similar crude? While MMS's newly proposed language on "second guessing" does state that the choice of the alternative with the lower price will not necessarily be taken as evidence of undervaluation, it would still seem to increase the lessee's risk of an adverse audit adjustment. The risk (actual or perceived) affects lessees' choices of market centers and pricing indices. It may also lead to more requests for advice being submitted to MMS than MMS currently anticipates, increasing the burdens of the rule on both lessees and the lessor.

9. **§ 206.103(d)** *If MMS determines that any of the index prices referenced in paragraphs (a), (b), and (c) of this section are unavailable or no longer represent reasonable royalty value, in any particular case, MMS may establish reasonable royalty value based on other relevant matters.*

   Again, MMS is left with complete discretion over what is to be considered a reasonable valuation result from MMS' own prescribed valuation method. Further, MMS does not define or limit what "other relevant matters" will be used as a basis for establishing an alternative, "reasonable" valuation.

10. **§ 206.103(e)(2)** *You must provide adequate documentation and evidence demonstrating the market value at the refinery. That evidence may include, but is not limited to: (i) Costs of acquiring other crude oil at or for the refinery; (ii) How adjustments for quality, location, and transportation were factored into the price paid for other oil; (iii) Volumes acquired for*

and refined at the refinery, and (iv) Any other appropriate evidence or documentation that MMS requires lessor at no cost to the Federal Government.

There are serious problems with the proposed rules governing cases where producers transport their production directly to their own refinery. First, the proposed index-based rule requires that the nearest market center spot price be used to represent the value at the refinery, and that "actual" transportation costs between the lease and refinery be used as a proxy for "the difference in value due to the location difference between the lease and the index pricing point."[38] It is not clear to us how transportation costs between a lease and refinery can reasonably represent the location and quality differences between the index pricing point and the refinery. And, it does not appear that MMS has analyzed how large the difference between these two concepts may be.

Second, if a lessee believes that the index-based method does not work for their situation, they are required to "provide adequate documentation and evidence" supporting an value at the refinery (i.e., not value at the lease). A key problem with this is that it generally may not be possible to observe actual values at the refinery inlet and, thus, to justify and defend any given result. There does not generally exist a market at the refinery. Refineries typically do not buy crude oil at the refinery inlet, but purchase it from a variety of locations (such as leases, market centers, aggregation points, etc.) and/or obtain it directly from their own production sources. MMS does not provide guidance on how to determine refinery value, or how to appropriately adjust refinery values for location, quality and transportation differentials back to the lease.

Finally, the provision that the lessee/refiner provide "Any other appropriate evidence or documentation that MMS requires" seems unduly broad. For example, this provision appears to give MMS the authority to seek information about the values of refined products and the costs of producing, which could be used in an attempt to value the oil based on a net-back from the values of refined products. Such a possibility would surely raise the anticipated audit costs imposed under the rule. We presume that this is not MMS' current intention, but the rule should be written to limit MMS from pursuing such an approach in the future.

11. **§ 206.110(a)(1)** *If MMS determines that the contract reflects more than the consideration actually transferred either from your or your affiliate to the transporter for the transportation, MMS may require that you calculate the transportation allowance under §206.111*

This provision allows MMS the discretion to override the use of actual transportation costs from arm's-length transportation contracts in favor of the transportation allowance calculation prescribed for non-arm's-length transportation arrangements in cases where MMS disagrees with the former. In addition, the proposed rule does not take into account that the data required to calculate "actual" transportation costs under §206.111 may not be available to the lessee in the case of an arm's-length transportation contract, since the lessee would not be privy to the detailed financial information of an unaffiliated transporter (or, in some cases, perhaps even an affiliated transporter).

[38] 64 Fed. Reg. 73836

12 **§ 206,111(i)(2)** *You may propose to MMS a cost allocation method on the basis of the values of the products transported. MMS will approve the method if it is consistent with the purposes of the regulations in this subpart.*

When calculating the transportation allowance under a non-arm's-length agreement in which more than one liquid is transported, the proposed rule generally requires a lessee to allocate the costs of the liquid products transported in proportion to their respective volumes. Although lessees may choose to propose a cost allocation method based on values rather than volumes, the proposed rule provides no information on the kinds of cases in which this might be allowed.

13. **§ 206.112(b)** *For non-arm's-length exchange agreements, you must request approval from MMS for any location/quality adjustment*

In the case of every single non-arm's-length exchange agreement, lessees will be required to request explicit approval of location/quality adjustments. By MMS' estimates (pp. 10 11 of its "Threshold Analysis"), 45 lessees would submit to MMS for approval a total of 3,866 non-arm's-length exchange agreements *each month*. Apart from the administrative burden to industry and MMS (for which MMS has provided an estimate), MMS does not appear to have considered whether this volume of exchange agreements can be evaluated for approval (or denial) each month in sufficient time to allow lessees to make timely royalty payments

14 **§ 206.112(f)** *If you cannot determine your location/quality adjustment under paragraph (a) or (c) of this section, you must request approval from MMS for any location/quality adjustment.*

MMS believes "that lessees using index pricing generally would have sufficient information to accurately determine location, quality, and transportation differentials, with relatively rare exceptions."[39] However, this statement does not appear to be supported by any information in the proposed rule about how the reasonableness of location, quality, and transportation adjustments might be judged. It is not clear whether MMS has performed an analysis of the information typically available to lessees to whom § 206.112 would apply in order to determine whether that information would be adequate to estimate adjustments that would meet MMS' approval. There is sufficient uncertainty surrounding this issue that many lessees who may have the information necessary to estimate the adjustments might, nevertheless, apply to MMS for guidance or approval in order to mitigate audit risk.

15 **§ 206.113** MMS periodically will publish in the Federal Register a list of market centers MMS will monitor market activity and, if necessary, add to or modify the list of market centers and will publish such modifications in the Federal Register.

MMS' identifies several factors and conditions (including "other relevant matters") that it may consider in determining whether to identify particular locations as market centers for the purpose of index-based pricing. However, the criteria for specifying market centers have not

[39] Threshold Analysis, p. 7.

been specified in any detail. In addition, no mechanism is provided in the proposed rule for a lessee to appeal subtractions from or additions to the list of approved market centers if changes in that list should have an adverse impact on the lessee. Also, MMS has not considered or estimated the impacts on or costs to lessees of changes in the list of approved market centers.

16. **§ 206.115(b)** *For new transportation facilities or arrangements, base your initial deduction on estimates of allowable oil transportation costs for the applicable period. Use the most recently available operations data for the transportation system or, if such data are not available, use estimates based on data for similar transportation systems.*

In the case of new transportation systems for which data are not yet available, it is not clear how a lessee would obtain the requisite detailed data on "similar transportation systems" required to produce a reasonable and defensible estimate of transportation deductions in a non-arm's-length transportation arrangement. As pointed out above in our comments of § 206.110(a)(1), such data are unlikely to be available to lessees to whom this section applies.

Section 206.102 - Arm's Length Sales by Lessee or Affiliate of Lessee Under December 30, 1999 MMS Proposed Oil Valuation Rule